

**Franchise Tax Board****ANALYSIS OF ORIGINAL BILL**

Author: Allen Analyst: David Scott Bill Number: ABX1 40  
Related Bills: See Legislative History Telephone: 845-5806 Introduced and amended Date: August 29, 2011 & September 1, 2011  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Employer Hiring Credit/Business Income Apportionment/Mandatory Single Sales Factor & Add Elective Four Factor Formula

**SUMMARY**

This bill would do the following:

Provision No. 1:

Expand the current New Jobs Tax Credit to taxpayers that employ 50 or fewer employees and increase the amount of the credit to \$4,000 for taxable years beginning on or after January 1, 2012.

Provision No. 2

For taxable years beginning on or after January 1, 2012:

- Repeal the annual election to use single sales factor;
- Require taxpayers not in a qualified business activity or that make an election to use the four-factor formula to use a mandatory single sales factor;
- Require all taxpayers to use the "market rule" for assigning sales to the sales factor; and
- Allow qualified taxpayers to assign 50 percent of the mandatory sales factor to California.

This analysis will not address the bill's provision for sales and use tax exemption for certain qualified tangible personal property as it does not impact the department or state income tax revenue.

**RECOMMENDATION AND SUPPORTING ARGUMENTS**

No position.

**Summary of Amendments**

The September 1, 2011, amendments deleted the changes made in the original bill to the ordering of paragraphs within the subdivision that defines a "qualified business activity". The bill originally changed the order to be an alphabetical ordering of each activity listed. The September 1, 2011, amendments made non-substantive changes to various code sections and cleaned up an obsolete paragraph. The September 1, 2011, amendments modified the operative date language for the section that describes how to assign sales of other than tangible personal property to this state.

Board Position:

\_\_\_\_\_ S \_\_\_\_\_ NA \_\_\_\_\_ X NP  
\_\_\_\_\_ SA \_\_\_\_\_ O \_\_\_\_\_ NAR  
\_\_\_\_\_ N \_\_\_\_\_ OUA

Executive Officer

Date

Selvi Stanislaus

09/15/11

## Summary of Suggested Amendments

Amendments 1 through 6, provided, would make technical corrections in the single sales factor provision to address the technical considerations listed below.

## PURPOSE OF THE BILL

According to the text of the bill, the purpose is to address the fiscal emergency declared by the Governor by proclamation on January 20, 2011.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment. The operative dates of these provisions vary and are addressed separately for each provision.

## ECONOMIC IMPACT – SUMMARY REVENUE TABLE

Estimated Revenue Impact of ABX1 40 as Amended on September 1, 2011 For Tax Years Beginning On Or After January 1, 2012 Enactment Assumed After June 30, 2011				
	2011-12	2012-13	2013-14	2014-15
Job Tax Credit	-\$30,000,000	-\$49,000,000	-\$11,000,000	\$33,000,000
Mandatory SSF	\$390,000,000	\$1,000,000,000	\$1,000,000,000	\$1,000,000,000
Special sales rule-cable corps	-\$12,000,000	-\$34,000,000	-\$37,000,000	-\$38,000,000
<b>Net Fiscal Impact</b>	\$348,000,000	\$917,000,000	\$952,000,000	\$995,000,000

## PROVISION NO. 1 EXPAND JOBS CREDIT

### Sections 17053.80 and 23623

## EFFECTIVE/OPERATIVE DATE

The changes made to the New Jobs Tax Credit would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2012, and before January 1, 2014.

## **ANALYSIS**

### **FEDERAL/STATE LAW**

Current state law, SBX 3 15 (Calderon, Stats. 2009, Third Extraordinary Session, Ch. 17) allows a credit for taxable years beginning on or after January 1, 2009, for a qualified employer in the amount of \$3,000 for each qualified full-time employee hired in the taxable year, determined on an annual full-time basis equivalent. The calculation of annual full-time basis is based on the total number of hours worked for the taxpayer by the employee (not to exceed 2,000 hours per employee) divided by 2,000. This credit is allocated by the Franchise Tax Board (FTB) and has a cap of \$400 million for all taxable years. The credit remains in effect until December 1 of the calendar year after the year in which the cumulative credit limit has been reached and is repealed after that date. Any unused credit may be carried forward up to eight taxable years.

A qualified employer is a taxpayer employing 20 or less employees.

### **THIS PROVISION**

For taxable years beginning on or after January 1, 2012, and before January 1, 2014, this provision would make the following changes to the New Jobs Tax Credit:

- Redefine a qualified employer as one that as of the previous taxable year employs 50 or fewer employees, and.
- Increase the amount of credit for each full time equivalent increase from \$3,000 to \$4,000.

The credit would be repealed December 31, 2014.

## **LEGISLATIVE HISTORY**

AB 236 (Swanson, 2011/2012) would allow a credit of \$5,000 for each full-time employee hired that is either an ex-offender or has been unemployed for 12 consecutive months. This bill was held under submission in the Assembly Revenue and Taxation Committee.

AB 304 (Knight, 2011/2012) would allow a credit of \$3,000 or \$5,000, dependent on the specified criteria, to an employer with 30 or more employees that moves or establishes a headquarters within California. This bill is currently in the Assembly Revenue and Taxation Committee.

AB 1009 (Wieckowski, 2011/2012) would modify the current New Jobs Tax Credit to increase the allowance of the credit from employers with fewer than 20 employees to employers with 100 or fewer employees. This bill was held under submission in the Assembly Revenue and Taxation Committee.

AB 1195 (Allen, 2011/2012) would modify the current New Jobs Tax Credit to increase the allowance of the credit from employers with fewer than 20 employees to employers with 50 or fewer employees. Additionally, this bill would increase the credit to \$4,000. This bill was held under submission in the Senate Appropriations.

SB 640 (Runner, 2011/2012) would allow a credit of \$500 per month for each full-time employee hired who has received unemployment benefits for six months prior to being hired. This bill was held under submission in Senate Appropriations.

AB 340 (Knight, 2009/2010) would have allowed a hiring credit to employers who established a headquarters within California. This bill failed passage out of the Assembly Revenue and Taxation Committee.

ABX3 15 (Stats. 2009, Ch. 10) and SBX3 15 (Stats. 2009, Ch. 17) provide for a tax credit of \$3,000 for each net job increase.

SB 508 (Dutton, 2009/2010), SBX6 11 (Dutton, 2009/2010), and SBX8 59 (Dutton, 2009/2010) are identical. These bills would have provided a tax credit for the first \$6,000 of wages paid or incurred to an individual documented by the Employment Development Department. SB 508 failed passage out of the Senate Revenue and Taxation Committee by the constitutional deadline; SBX6 11 (Dutton, 2009/2010) failed passage out of the Senate Revenue and Taxation Committee; SBX8 59 failed passage out of the Senate Revenue and Taxation Committee without further action.

SB 612 (Runner, 2009/2010) would have provided a tax credit of \$500 per month for each qualified employee employed by a taxpayer. This bill failed passage out of the Senate Revenue and Taxation Committee.

## **PROGRAM BACKGROUND**

As of August 6, 2011, the total Personal Income Tax and Business Entity returns claiming the New Jobs Tax Credit was 10,435, and the amount of credits claimed was \$61.4 million. The cut-off date will be the last day of the calendar quarter within which the FTB estimates it will have received timely filed original returns claiming the credit that cumulatively total \$400 million.

## **OTHER STATES' INFORMATION**

The states surveyed include *Florida, New York, Illinois, Massachusetts, Michigan, and Minnesota*. These states were selected due to their location and similarities to California's economy, business entity types, and tax laws.

*Florida* allows businesses located in an Enterprise Zone (EZ) a credit based on wages paid to new employees. Other wage-based credits are offered to businesses that are located in high crime areas or in rural areas.

*New York* allows a wage credit to a business that hires a full-time employee (either one in targeted group or not) for a newly created job in an Empire Zone.

*Illinois* allows a job tax credit for taxpayers conducting a trade or business in an EZ or a High Impact Business. The credit is \$500 for each eligible employee hired to work in the zone during the tax year. It is available for eligible employees hired on or after January 1, 1986.

*Massachusetts* allows a Full Employment credit to employers who participate in the Full Employment Program and continue to employ a participant for at least one full month. The taxpayer may claim a credit of \$100 per month of eligible employment per participant, up to \$1,200 per participant.

*Michigan* and *Minnesota* do not offer wage credits.

## **FISCAL IMPACT**

This provision would require a calculation for the credit that would require the existing New Jobs Tax Credit form to be modified. These changes could be incorporated into the department's annual changes, and as such, the costs would be minor.

### **PROVISION NO. 2: MANDATORY SINGLE SALES FACTOR**

#### **Sections 23101, 25128, 25136, and 25136.1**

## **ANALYSIS**

### **STATE LAW**

Current state law provides the following general rules to determine the amount of income reportable to California for entities that conduct business both within and outside of California.

#### **Doing Business in California**

In 2009, California established a bright-line test to determine if a taxpayer is doing business in California. The test is met if any of the following are satisfied.<sup>1</sup>

- The taxpayer is organized or commercially domiciled in California.
- The taxpayer's sales in California exceed the lesser of \$500,000 or 25 percent of the taxpayer's total sales, including sales by an agent or independent contractor.
- The real and tangible personal property owned or rented by the taxpayer in California exceeds the lesser of \$50,000 or 25 percent of the total owned or rented real and tangible personal property.
- The amount of compensation paid to an employee by the taxpayer in California exceeds the lesser of \$50,000 or 25 percent of the total compensation paid by the taxpayer.

If the taxpayer meets the bright-line test, then it must apportion its income to California using the applicable apportionment formula.

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<sup>1</sup> Federal law, commonly referred to by tax practitioners as PL 86-272, still applies to sellers of tangible personal property. As a result, if a taxpayer's activities in California stay within the protections of PL 86-272, a taxpayer also remains protected from the imposition of those taxes that are computed based on net income, namely, the California franchise and income tax. Nevertheless, if a taxpayer is considered doing business in California under Revenue and Taxation Code (R&TC) Section 23101(a) or (b), it still has a filing requirement and will be subject to the minimum tax because that tax is not computed based on net income and therefore is not subject to the protections of PL 86-272.

## Apportionment Formula

State law uses an apportionment formula to determine the amount of “business” income attributable to California.<sup>2</sup> The apportionment formula consists of property, payroll, and sales factors. Each of these factors is a fraction: the numerator is the value of the item in California and the denominator is the value of the item everywhere. The property factor generally includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; and the sales factor generally includes all gross receipts from the sale of tangible and intangible property.

$$\frac{\text{Property Factor}}{\frac{\text{Average California Property}}{\text{Average Total Property}}} + \frac{\text{Payroll Factor}}{\frac{\text{California Payroll}}{\text{Total Payroll}}} + (2 \times \frac{\text{Sales Factor}}{\frac{\text{California Sales}}{\text{Total Sales}}}) = \text{California Apportionment Factor}$$

4

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been a three-factor apportionment formula consisting of property, payroll, and double-weighted sales (three-factor, double-weighted sales,<sup>3</sup> illustrated above). An exception to this rule exists for taxpayers of an apportioning trade or business that derive more than 50 percent of its gross business receipts from conducting a “qualified business activity.”<sup>4</sup> These “qualified business activity” taxpayers are required to use a three-factor, single-weighted sales,<sup>5</sup> apportionment formula (illustrated below).

$$\frac{\text{Property Factor}}{\frac{\text{Average California Property}}{\text{Average Total Property}}} + \frac{\text{Payroll Factor}}{\frac{\text{California Payroll}}{\text{Total Payroll}}} + \frac{\text{Sales Factor}}{\frac{\text{California Sales}}{\text{Total Sales}}} = \text{California Apportionment Factor}$$

3

<sup>2</sup> “Business income attributable to California” is a taxpayer’s “business income” multiplied by its California apportionment formula. R&TC section 25120(a) defines “business income” as income arising from transactions and activities in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.

<sup>3</sup> This formula is sometimes referred to as the “four-factor” formula because of double weighting of the sales and the denominator used is “4.”

<sup>4</sup> Extractive, agriculture, savings and loan, and banks and financials.

<sup>5</sup> This formula is sometimes referred to as the “three-factor” formula because the sales are single weighted and the denominator used is “3.”

For taxable years beginning on or after January 1, 2011, an apportioning trade or business (other than an apportioning trade of business that derives more than 50 percent of its gross business receipts from conducting a qualified business activity), is allowed to make an annual, irrevocable election to utilize a single factor, 100 percent sales (single sales factor), apportionment formula instead of the three-factor, double-weighted sales apportionment formula.

California Sales equals California apportionment factor  
Total Sales

The election must be on a timely-filed original return in the manner and form prescribed by the FTB.

### Assignment of Sales Rules

California has two basic rules for assigning sales.

An apportioning trade or business that has not made an election to utilize the single sales factor apportionment formula must use the pre-2011 income producing activity/cost of performance rules (see below) to assign all sales other than sales of tangible personal property, regardless of taxable year.

If the single sales factor election is made inoperative, all apportioning trades or businesses would be required to use the pre-2011 rules (see below) for assigning all sales other than sales of tangible personal property, commonly called "cost of performance."

An apportioning trade or business that has made a single sales factor election must utilize the post-2010 rules (see below) operative for years beginning on or after January 1, 2011, commonly referred to as the "market rule," to assign all sales other than sales of tangible personal property, namely sales of intangibles and services.

### **Pre-2011 Rules For Assigning Sales**

#### Sales of Tangible Personal Property before 2011 (Joyce Rule)

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped from California to a purchaser out of state, and the taxpayer (seller) is not taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods are shipped from California.

This is commonly called the Joyce rule because the rule was declared in a decision of the Board of Equalization.

### Sales of Other Than Tangible Personal Property (Intangibles and Services)

- Sales from intangibles and all other services are assigned to California if the income producing activity that gave rise to the receipts is performed wholly within California. If the income producing activity is performed within and outside the state, the sales from intangibles and all other services are assigned to California if the greater cost of performance of the income producing activity is performed in this state. For example, a taxpayer provides non-personal services to a client in California. The taxpayer incurs direct costs (salaries, equipment costs, etc.) to provide the service in Oregon and California. The total costs are \$10,000. The Oregon costs are \$4,800 (48%). The California costs are \$5,200 (52%). Based on the greater cost of performance, 100 percent of the receipts for the service provided to the California client would be assigned to California.
- Sales from the performance of personal services are assigned to California if the services are performed in California. If personal services are performed in more than one state, the receipts from the services are assigned to California based on the ratio of time spent performing such services in the state to total time spent in performing such services everywhere. For example, a taxpayer provides personal services for a single client in Oregon, Nevada, and California. The total time spent is 1,000 hours for all of the services. The hours are divided between the states as follows: 600 hours in Oregon, 100 hours in Nevada, and 300 hours in California. The total receipts for the services for the client are \$20,000. Based on the ratio of time spent, the amount assigned to California is \$6,000, which is 30 percent of the total time.
- Sales from the sale, rental, lease, or licensing of real property and the receipts derived from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

### **Post-2010 Rules For Assigning Sales**

#### Sales of Tangible Personal Property (*Finnigan* Rule)

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) or any member of the taxpayer's combined reporting group<sup>6</sup> is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser out of state and neither the taxpayer (seller) nor any other member of the combined reporting group is taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods are shipped from California.

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<sup>6</sup> A combined report is a report (a single tax form for the group) in which the business income and apportionment factors of a unitary group of corporations are combined for purposes of determining each taxpayer's share of the California unitary business income. A combined reporting group would be all of the taxpayers included in a single combined report.



Sales of Other Than Tangible Personal Property (Intangibles and Services)

- Sales from services are assigned to California to the extent the purchaser of the service receives the benefit of the service in California. (Market Rule)
- Sales from intangible property are assigned to California to the extent the property is used in California. In the case of marketable securities, sales are assigned to California if the customer is in California. (Market Rule)
- Sales from the sale, lease, rental, or licensing of real property are assigned to California if the real property is located in California.
- Sales from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

THIS PROVISION

This provision would do the following:

- Makes the single sales factor apportionment formula mandatory for all apportioning trade or businesses, except those in a qualified business activity (extractive, agricultural, savings and loans, and banks and financials) or those apportioning trade or businesses that make an election to use the four-factor formula. The election is only available if the tax, before credits, using the four-factor formula is not less than the tax, before credits, using the single sales factor apportionment method. This election is available for taxable years beginning on or after January 1, 2012.
- Repeals the elective single sales factor provisions for years beginning on or after January 1, 2012.
- Removes references to the provisions of the repealed elective single sales factor.
- Revises the provision that determines how to assign sales of other than tangible personal property, to require the use of "cost of performance" for assigning sales for taxable years beginning before January 1, 2012, and require all taxpayers, including those businesses in a qualified activity, to use the "market rule" for assigning sales of other than tangible personal property to California for taxable years beginning on or after January 1, 2012.
- Adds a provision to allow qualified taxpayers to exclude 50 percent of the total California sales of the apportioning trade or business determined under the market rule from the numerator of their single sales factor. A qualified taxpayer means:
  - a member of a combined reporting group that is also a qualified group; and
  - a qualified group that satisfies both of the following conditions:
    - has a minimum investment of \$250,000,000 in California for the taxable year; and
    - for 2006, derived more than 50 percent of its U.S. network gross business receipts from operations of one or more cable systems.

## TECHNICAL CONSIDERATIONS

Paragraph (2) of subdivision (a) of Section 25128 refers to “an apportioning trade or business described in paragraph (1)”. However, there is not a description of an apportioning trade or business in paragraph (1). This reference should be deleted. Amendment 1 is provided.

Subparagraph (B) of paragraph (7) of subdivision (d) of Section 25128, references Section 25128.5. Section 25128.5 is not operative after December 31, 2011. The reference should be deleted. Amendment 2 is provided.

The operative date language for subdivision (a) of section 25136 was changed. The changes make the subdivision operative for taxable years before January 1, 2012, for which Section 25128.5 is operative. The operative dates should be for taxable years before January 1, 2011, and for taxable years beginning on or after January 1, 2011 and before January 1, 2012, for which Section 25128.5 is operative. Amendment 3 is provided.

SEC. 11 adds new section 25136.1, which is the rules for the “market rule” for assigning sales, other than the sales of tangible personal property. To prevent confusion, this section number should remain as 25136. Amendment 4 is provided.

There is a need to clarify what sales Section 25136.1 applies to. It should apply to sales, other than the sale of tangible personal property. Amendment 5 is provided.

## **LEGISLATIVE HISTORY**

SB 116 (DeLeon, 2011/12) would have mandated the use of the single sales formula for all companies except for financial institutions and oil companies, which, as under current law, would continue to use the three-factor formula; qualified cable companies; and those companies that elect to use the four-factor formula, if the “tax” using the four-factor formula is higher than the “tax” using the single sales factor method of apportioning income to California. This bill is currently in the Senate for a third reading.

AB 1935 (DeLeon, 2009/10) would have mandated the use of the single sales formula for all companies except for financial institutions and oil companies, which, as under current law, would continue to use the three-factor formula. This bill was held in the Assembly Appropriations Committee.

SB 858 (Stats. 2010, Ch. 721, Committee on Budget and Fiscal Review), among other things, reinstated the “cost of performance” rules for assigning the sales of intangibles and services for non-electors of the single sales factor formula.

SBX3 15 (Stats. 2009/10 Third Extraordinary Session, Ch. 17, Calderon), allowed specific entities to elect to utilize a sales only formula to apportion its income subject to franchise or income tax and modified the rules for assigning certain receipts for inclusion in the sales factor.

SBX6 18 (Steinberg and Alquist, 2009/10) would have required the use of the single sales factor formula for apportioning income for taxpayers not in a qualified activity. No hearing was held for the bill.

## **OTHER STATES' INFORMATION**

In addition to California, 24 states have implemented or are in the process of phasing-in the single factor apportionment method. Of these, 18 states require use of the single sales factor: Colorado, Georgia, Illinois, Indiana, Iowa, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, New York, Oregon, South Carolina, Texas, Washington, and Wisconsin. Only one state (Missouri) is like California's law, which allows corporations to annually elect which formula they prefer.

## **FISCAL IMPACT**

This provision would not significantly impact the department's costs.

## **SUPPORT/OPPOSITION**

None identified.

## **ARGUMENTS**

Pro: Supporters would argue that the new jobs credit provision would stimulate job creation by offering a tax incentive to businesses that have the ability to employ new workers and expand their current workforce. The single sales factor provision would make California consistent with the movement by other states to move to a mandatory single sales factor for all apportioning taxpayers doing business in this state.

Con: Opponents might argue that not all business models fit easily into a single sales calculation and that mandatory single sales factor negates the importance of out of state business contributions to the states overall economic health.

## **LEGISLATIVE STAFF CONTACT**

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO ABX1 40 AS AMENDED ON SEPTEMBER 1, 2011

AMENDMENT 1

On page 20, line 11, strikeout "described in paragraph (1)"

AMENDMENT 2

On page 22, line 3, strikeout "25128.5 or"

AMENDMENT 3

On page 23, lines 16, after "January 1," insert:

2011, and for taxable years beginning on or after January 1, 2011, and before January 1,

AMENDMENT 4

On page 24, line 18, strikeout "25136.1", and insert:

25136

AMENDMENT 5

On page 24, line 20, strikeout "25136.1", and insert:

25136

AMENDMENT 6

On page 24, line 21, after "sales" insert:

, other than sales of tangible personal property,